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Before the

Subcommittee on Finance and Hazardous Materials
Committee on Commerce, U.S. House of Representatives

Hearing on Financial Services Reform Proposals

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Mr. Chairman, Congressman Manton, and Members of the Subcommittee, thank you for inviting me to testify on this important subject.

I am Mark Sutton. I am Executive Vice President of Paine Webber Group, Inc. ("PaineWebber") and Director of PaineWebber's Private Client Group. PaineWebber is an independent, full-service national securities firm, with more than two million clients and 16,000 employees worldwide.

The issues you have asked us to address in this hearing are critical to the continued growth and vibrancy of the U.S. economy and to the savings and retirement security needs of millions of Americans.

Before discussing the subject of financial services reform, let me note that your Committee was responsible for moving legislation through the last Congress that became the Private Securities Litigation Reform Act of 1995 and the National Securities Markets Improvement Act of 1996. Each of these initiatives was designed to benefit investors and enhance the competitiveness of the U.S. capital markets: the first by curbing frivolous and costly securities class action strike suits; the second by removing overlapping and costly layers of regulation. I

want to thank you for all of the hard work that led to the enactment of those important reforms.

While the Commerce Committee and this Subcommittee have been deeply involved in the issues of financial modernization for many years, I want to urge you to take an even greater leadership role in this Congress in achieving the passage of legislation in this area. Like the reform efforts you led in the last Congress, financial services reform bears directly on the efficiency and competitiveness of our markets.

It is particularly appropriate that this Subcommittee be a full participant in the debate because, in the past, proposals for financial modernization have been viewed almost entirely as a debate about "What powers should be authorized for banking organizations?" As Members of this Subcommittee know, that perspective is simply too limited. One striking fact underscores this point: Today, Americans put more of their savings in mutual funds than in insured bank accounts.[1]

We are all in the financial services business -- banks and savings institutions, insurance companies, finance companies, securities broker-dealers and mutual funds. We are all developing strategies to meet our customers' savings and investment needs into the next century, and we are operating in an environment

[1] See Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before the Committee on Banking and Financial Services Subcommittee on Financial Institutions and Consumer Credit, February 13, 1997, note 1.

where technology offers new opportunities, and presents new risks, on almost a daily basis. Financial services firms need to be lean and efficient; we also need to be flexible.

But, this "real world" environment notwithstanding, the regulatory environment in which we operate is grounded in statutes that are 60 or more years old, in piecemeal actions by regulators who have sought to accommodate an evolving marketplace, and in judicial decisions that have emanated from challenges to the actions of regulators. This has led to tremendous inefficiencies and transaction costs.

Banking organizations now are firmly in the securities business. With the sole exception of serving as a distributor of mutual funds, there is no securities activity that PaineWebber can do that a "Section 20" affiliate of a bank holding company cannot do.[2] And, depending upon the nature of applications that may be approved by the Comptroller of the Currency under its new "Part 5" rules, subsidiaries of national banks soon may be our direct competitors.[3]

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[2] As the Subcommittee is aware, the Board of Governors of the Federal Reserve System ("Federal Reserve Board") in recent months has increased from 10 percent to 25 percent the amount of revenue a "Section 20" affiliate of a bank holding company may derive from underwriting and dealing in securities other than U.S. and Canadian government obligations and municipal general obligation bonds. The Federal Reserve Board also reduced certain "firewalls" previously imposed between banks and their Section 20 affiliates.

[3] The Office of Comptroller of the Currency ("OCC") last fall adopted its Part 5 operating subsidiary rules, which will permit subsidiaries of national banks to engage in activities that are "part of or incidental to the business of banking," but not permissible for the parent bank to engage in directly. Although the OCC has not yet approved such activities, it is anticipated that they could involve, among other things, underwriting and dealing in corporate debt and equity and municipal revenue bonds -- essentially the same kinds of activities in which Section 20 subsidiaries of bank holding companies may engage.

Of course, securities firms, too, are involved in aspects of the business of banking. For example, securities firms can provide transaction accounts, credit cards, travelers checks, loans and other financings. They can own or affiliate with a foreign bank or with a state chartered trust company. They also can own or affiliate with a federal savings bank, a credit card bank, or an industrial loan company, all of which accept FDIC-insured deposits. But the securities activities in which banking organizations can engage and the banking activities in which securities firms can engage are exercised unevenly, incompletely, and under different regulatory schemes. We all compete in the same game, but under different sets of rules. Financial services organizations find themselves weaving through the field, around regulatory impediments and through regulatory "loopholes." As I mentioned, significant inefficiencies and transactions costs are the result.

Let me give you two examples.

Increasingly, the business of any financial services firm is to help its individual customers protect, accumulate, and save assets -- for their own financial security and the security of their families. Trust services are an essential part of financial services offered to meet these objectives. But, because full services securities firms are barred from owning any national trust company (all of which are members of the Federal Reserve System,[4]) they are barred from the most

[4] Section 20 of the Glass Steagall Act, 12 U.S.C. ' 377, Banking Act of 1933.

efficient means of offering trust services nationwide. They can, of course, enter into contractual arrangements with banks to offer such services; they also can establish separate trust companies on a state-by-state basis -- with significant costs.

Financial services firms also are in the business of handling the financing needs of their business customers, including commercial lending. But securities firms are prohibited from owning any U.S. FDIC-insured commercial bank.[5] They can, as I mentioned, own or affiliate with a federal savings bank and make consumer loans, but federal thrifts are limited in the amount of commercial loans they can make.[6] Securities firms can make commercial loans in the U.S. through offshore bank affiliates. But, these are simply indirect ways of doing what they could be able to do directly and more efficiently if permitted to own a commercial bank.

If we accept that banking organizations already are, and should be, in the securities business and securities firms are, and should be, in the banking business, the question I believe Congress must address is how to make those businesses operate as efficiently and fairly as possible, with protection for investors, depositors, and taxpayers.

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[5] Banking Holding Company Act of 1956, 12 U.S.C. ' 1841 et. seq.

[6] Section 5(c)(2)(A) of the Home Owners' Loan Act, 12 U.S.C. ' 1464.

Flexible, "Functional" Regulatory Structure Needed

As I mentioned earlier, for too long the debate over financial modernization has been viewed primarily in terms of "bank powers." It therefore is understandable that, when contemplating a regulatory scheme under which banking organizations can engage in the securities business, policy-makers naturally default to the bank regulatory model and, in particular, the banking holding company model. But I believe it will be detrimental to investors and to the competitiveness of our securities markets if we seek to impose bank-like regulation on organizations within which both banks and securities firms affiliate.

We have built a vibrant securities industry in this country -- and have achieved the fairest and most liquid capital markets in the world -- under a regulatory system based on "functional" regulation of securities broker-dealers by the Securities and Exchange Commission without regulation at the holding company level. Section 17(h) of the Securities Exchange Act of 1934 sets out a narrow requirement for "risk assessment" reporting of the activities of unregulated affiliates of broker-dealers. This system has worked well, and the SEC -- which is not bashful when it comes to asking for new authority -- has testified that there is no need for further regulation of holding companies that have broker-dealer subsidiaries.

The securities model should work well in financial services companies in

which both SEC-registered broker-dealers and regulated banks affiliate. The sharing of information about one affiliate in a holding company that can present risks to another is essential. However, we believe that there is no need for an "umbrella" regulator of the holding company system and we would oppose the imposition of bank-like regulation on the activities of the holding company as a whole. Securities organizations must be able to act fast, or lose business to foreign competitors. Imposing a time-consuming application process prior to engaging in any new activity would guarantee loss of market share.[7]

We also would oppose limitations on the affiliation of securities firms and banks when the securities firms own, or are part of, nonfinancial companies. There are successful examples of nonfinancial companies that have been affiliated with credit card banks or federal savings banks for years; there also are examples of nonfinancial companies that have owned securities broker-dealers. The traditional view of the need for separation of "banking and commerce" should give way to the reality of today's global and highly competitive marketplace.

Moreover, there is a fairness issue here. If legislation restricts financial services holding companies to a permissible "basket" of nonfinancial activities that is too narrow, then securities firms that have been affiliated with nonfinancial businesses for years might have to divest in order to affiliate with commercial banks. However, commercial banks would be able to affiliate with securities firms

[7] While the Federal Reserve appears to be making a serious effort to act on applications more expeditiously, there is a history of lengthy delays in its acting on applications of regulated entities seeking to enter into new lines of business.

without divesting of existing businesses.

We believe, for the most part, that financial services firms will remain principally financial services firms -- but there is no reason to straightjacket the industry at this time, or to force divestiture of existing nonfinancial businesses by securities firms that now seek to affiliate with banks.

There are three principal legislative proposals on the table. H.R. 10, introduced by Representative Leach, is modeled on the traditional bank holding company model. We oppose H.R. 10 for the reasons discussed. H.R. 268, introduced by Representative Roukema, is an extremely constructive proposal. It attempts to provide flexibility for financial services organizations that include both regulated securities firms and banks, as well as a "basket" of nonfinancial businesses. However, it does not provide the full flexibility we believe financial services organizations need. The third approach, S. 298 in the Senate and H.R. 699 in the House, introduced by Senator D'Amato and Representative Baker, respectively, would permit financial services organizations and commercial firms to affiliate in a holding company structure, with regulated entities subject to requirements of their respective banking, securities and insurance regulators under a functional regulation scheme. In our view, the D'Amato/Baker approach is the ideal model for financial services organizations in the 21st Century.

Chairman Oxley, Members of the Subcommittee, thank you again for

inviting me to testify this morning. I would be pleased to answer any questions you may have.